September 15, 2021

House Ways and Means Committee Releases Proposed Tax Law Changes

House Ways and Means Committee Chairman Richard Neal Unveiled the Committee's Budget Proposal that Includes a Variety of Federal Income Tax Law Changes

SUMMARY

On September 13, 2021, House Ways and Means Committee Chairman Richard Neal introduced tax provisions of the Committee's proposed budget (the "W&M Budget Proposal"), which proposes substantial changes to the business, individual and international income tax regimes. Some important features of the draft legislation in these areas are outlined below.

DISCUSSION

A. BUSINESS TAXATION

- **Corporate Tax Rate.** The current corporate tax rate of 21% would be replaced with a graduated structure with a maximum rate of 26.5%. The dividends-received deduction available to domestic corporations would be increased in order to leave the tax rate on dividends received by such corporations approximately unchanged.
- **Partnership Interests Held in Connection with the Performance of Services.** The existing three-year holding period requirement that must be satisfied in order for long-term capital gains rates to apply to a holder of an "applicable partnership interest" (which generally includes carried interest received in exchange for services provided to certain investment businesses) would generally be extended to five years, except in the case of certain real estate businesses and for taxpayers with adjusted gross income below $400,000. Long-term capital gains treatment would be available only with respect to gains realized five years later than the later of (i) the date on which the taxpayer acquired substantially all of its applicable partnership interest and (ii) the date on which the applicable partnership acquired substantially all of its assets, with a requirement similar to (i) and (ii) applied in the case of tiered partnerships. In addition, gain would be required to be recognized upon any transfer of an applicable partnership interest, apparently without exception for charitable transfers, nonrecognition transfers or transfers upon death.

- **Changes to the Limitation on Business Interest Expense Deductibility.** In an effort to prevent a multinational group from shifting interest deductions to the U.S., the existing limitation on the deductibility of business interest expense would be expanded to limit the interest deduction available to a domestic corporation (or a foreign corporation engaged in a U.S. trade or business) that is part of a multinational group that prepares consolidated financial statements and has average annual interest expense in excess of $12 million. The limitation would equal 110% of the amount of the group's total worldwide interest expense (as reported on its financial statements) that is treated as attributable to the domestic corporation. Such attribution would be determined based on the ratio of the domestic corporation's EBITDA to the group's total EBITDA.
  - **Application to Passthrough Entities.** The application of the limitation on the deductibility of business interest expense to passthrough entities would be substantially revised. Under current law, this limitation is determined at the level of the partnership or S corporation, but under the W&M Budget Proposal, the limitation would be determined at the partner or shareholder level.
  - **Disallowed Interest Expense.** Interest expense the deduction of which is disallowed for a taxable year would be permitted to be carried forward for five years, rather than being carried forward indefinitely as under current law.
- **Limitation on Qualified Small Business Stock Gain Exclusion.** Under current law, individual, trust and estate taxpayers generally may exclude 100% of their gain realized on the sale of "qualified small business stock" acquired after September 27, 2010 (or 75% of gain with respect to stock acquired before such date and after February 17, 2009) to the extent such gain exceeds the greater of $10 million or 10 times the taxpayer's basis in the stock. Under the W&M Budget Proposal, taxpayers with adjusted gross income of $400,000 or more would be eligible to exclude only 50% of any such gain. This limitation would apply to all sales or exchanges occurring after September 13, 2021, except for sales or exchanges entered into pursuant to a binding contract in place on or before such date. This proposal could have significant impact for founders and venture capital investors in start-ups, and may make the corporate form relatively less attractive going forward.
- **Limitation on Deduction of "Excessive" Compensation.** The American Rescue Plan Act of 2021 enacted amendments to the existing rules that prevent certain publicly traded corporations from deducting compensation in excess of $1 million paid to certain officers. Those amendments would increase the number of employees whose compensation is subject to this limitation from five to 10 for any taxable year. The amendments as enacted are set to take effect for taxable years beginning after December 31, 2026, but the W&M Budget Proposal would change the effective date to taxable years beginning after December 31, 2021. Additionally, the W&M Budget Proposal would cause additional types of compensation, including performance-based compensation and post-termination compensation, to be subject to the deduction limitation and would add a new aggregation rule for purposes of determining the "employer" that is subject to the limitation.
- **Temporary Rule to Allow Certain S Corporations to Reorganize as Partnerships.** Under the W&M Budget Proposal, an S corporation that was an S corporation on May 13, 1996 and at all times thereafter would be permitted to elect to reorganize as a partnership for tax purposes during the two-year period beginning on December 31, 2021 without triggering gain recognition. This provision, which is a perhaps belated recognition that entities formed as S corporations prior to the "check-the-box" regime put in place in 1996 may now prefer to be organized as limited liability companies that are treated as partnerships for tax purposes, could benefit S corporation owners who would rather not to be subject to the complex requirements that apply to S corporations.
- **Treatment of Certain Losses.** Deductions for losses with respect to worthless securities and partnership interests would be treated as realized on the day that the event establishing worthlessness occurs. Such a loss with respect to a worthless partnership interest would generally be subject to the same treatment as a loss realized on the sale of a partnership interest.

- **Liquidation of Subsidiaries.** Losses realized upon a taxable liquidation of a corporate subsidiary would be deferred until the property received in the liquidation is sold to an unrelated party. This provision would restrict so-called internal *Granite Trust*-type transactions by preventing losses on the stock of corporate subsidiaries from being recognized prior to a third-party transaction.
- **Modification of REIT Constructive Ownership Rules.** Under current law, for purposes of determining whether a real estate investment trust ("REIT") derives a sufficient percentage of its income from rents from real property, payments received from entities in which the REIT owns 10% or more of the vote or value (after applying constructive ownership rules) are generally excluded. Under the W&M Budget Proposal, the applicable constructive ownership rules would be modified to prevent such rules from creating so-called "double downward" attribution, which under current law can cause a REIT to be treated as owning assets that the REIT does not actually economically own, such as assets owned solely by a joint venture partner of an owner of the REIT.
- **Adjusted Basis Limitation for Divisive Reorganizations.** "Debt for debt" exchanges that are a popular feature of many spin-off transactions (which, under current law, permit the embedded appreciation in the "SpinCo" to be monetized by way of paying off indebtedness of the parent corporation) would be limited to the basis of the assets transferred to "SpinCo", thus eliminating the main motivation for such exchanges.
- **Constructive Sales of Digital Assets; Wash Sales.** Digital assets, such as cryptocurrency, would be subject to the constructive sale rules, which are anti-abuse rules that, when applicable, require a taxpayer to recognize gain with respect to an appreciated financial asset as if such asset were sold for fair market value upon adopting an economically offsetting position with respect to such asset. In addition, commodities, currencies and digital assets (such as cryptocurrencies) would become subject to the "wash sale" rules, which currently apply only to "stock and securities" and generally prevent taxpayers from claiming losses from selling and reacquiring substantially identical assets.
- **Common Control.** Rules that aggregate multiple businesses for purposes of applying various provisions of the tax code (including the "small business" exception to the limit on the deductibility of business interest expense) would be revised to provide that non-corporate taxpayers engaged in activities treated as a trade or business for purposes of the passive activity loss rules, which includes any for-profit activity, would be treated as a "trade or business" that is subject to the aggregation rules.

B. INDIVIDUAL TAXATION

- **Increased in Individual Income Tax Rates.** The top marginal individual ordinary income tax rate would be increased from 37% to 39.6%, and the top long-term capital gains rate would be increased from 20% to 25%. The increased long-term capital gains rate would generally apply for transactions completed after September 13, 2021 (other than transactions pursuant to a binding contract entered into on or prior to such date). A 3% "surcharge" would also apply to individuals to the extent their modified adjusted gross income exceeds $5,000,000, or $2,500,000 for married individuals filing separately, and on trusts to the extent their modified adjusted gross income exceeds $100,000.
- **Application of Net Investment Income Tax to Trade or Business Income.** The 3.8% "net investment income tax" (also known as the "Medicare tax") would be expanded to cover net investment income above certain income thresholds for an individual, trust or estate that is derived in the ordinary course of a trade or business.
- **Limitation on Deduction of Qualified Business Income.** The 20% deduction for certain passthrough business income ("qualified business income") that was enacted in 2017 under Section 199A would be effectively eliminated for high income individuals. The maximum allowable deduction for qualified business income would be $500,000 in the case of a joint return, $400,000 for an individual return, $250,000 for a married individual filing a separate return, and $10,000 for a trust or estate.

- **Treatment of Grantor Trusts.** Under current law, a grantor trust is generally disregarded as separate from the grantor for income tax purposes, such that transactions between the grantor and the trust are generally not income tax events. However, under the W&M Budget Proposal, a sale between a grantor trust established after the date of enactment of the legislation (or the portion of a pre-existing grantor trust that is funded after such date) and its grantor owner would be treated as a sale between the grantor and a third party.
- **Limitations on Excess Business Losses of Non-Corporate Taxpayers.** The provision that disallows "excess business losses" (i.e., net business deductions in excess of business income) for non-corporate taxpayers that was enacted in 2017 and set to expire at the end of 2026 would be made permanent. In addition, excess business losses would be carried forward to future taxable years as excess business losses treated as recognized in such future taxable years (and thus would continue to be subject to the excess business loss limitation) rather than being carried forward as net operating losses.
- **Retirement Accounts.** The W&M Budget Proposal would make multiple significant changes to the taxation of retirement accounts, including individual retirement accounts ("IRAs").
  - **Retirement Plan Contribution Limits.** IRA contributions would be prohibited for a taxable year if the aggregate value of an individual's IRAs and defined contribution retirement accounts ("DRCAs") exceeds $10 million as of the end of the prior taxable year. Additionally, employers would be subject to reporting requirements for DCRAs with aggregate balances in excess of $2.5 million.
  - **Minimum Required Distributions.** An individual with an aggregate balance of $10 million or more in IRAs and/or DRCAs and annual taxable income above certain thresholds would be required to make minimum distributions from such accounts for each taxable year and would not be permitted to make further contributions to IRAs or Roth IRAs. The minimum distribution would generally equal 50% of the excess of the aggregate balance of such accounts above $10 million. An individual with an aggregate balance of $20 million or more in such accounts would be required to make a distribution of the lesser of the amount needed to bring the aggregate balance down to $20 million or the aggregate balance in the individual's Roth IRA(s) and Roth DRCA(s).
  - **Rollovers to Roth IRAs.** Taxpayers with income above certain minimum thresholds would be prohibited from converting IRAs and employer-sponsored retirement accounts to Roth IRAs, which would eliminate the so-called "back-door" Roth IRA conversions that effectively permit taxpayers to avoid the income limitations applicable to Roth IRA contributions under current law.
  - **Prohibitions on Certain IRA Investments.** IRAs would be prohibited from holding any investments that are not tradable on an established securities market and in which the IRA owner has a 10% direct or indirect ownership interest. Additionally, IRAs would be prohibited from investing in an entity in which the IRA owner is an officer. The W&M Budget proposal also provides that for purposes of the prohibited transaction rules, an IRA owner (as well as certain persons related to the IRA owner) would be treated as a "disqualified person".

C. INTERNATIONAL TAXATION

- **Reduction in GILTI/FDII Deduction.** The W&M Budget Proposal reduces the deduction with respect to "global intangible low-taxed income" ("GILTI") and "foreign-derived intangible income" ("FDII") to 37.5% and 21.875%, respectively. Taking into account the proposed corporate tax rate described above, the effective tax rates applicable to a domestic corporation would be 16.5625% for GILTI and 20.7% for FDII.
- **Country-by-Country Foreign Tax Credit Limitation Regime.** The W&M Budget Proposal would change the foreign tax credit limitation system such that credits would be grouped on a country-by-country basis, rather than calculating an aggregate limitation on a global basis. Taxpayers thus

generally would not be able to offset tax liability resulting from income recognized in low-tax countries against excess foreign tax credits resulting from taxes paid in high-tax countries. Taxpayers would allocate each item of income to one "taxable unit" of the taxpayer. Taxable units would include controlled foreign corporations ("CFCs") as well as passthrough entities and branches that are tax-resident in countries other than the country of organization of the taxpayer owner. The "separate limitation loss" rules would also apply on a country-by-country basis.

- The W&M Budget Proposal includes various other revisions to the foreign tax credit regime. For example, the W&M Budget Proposal would eliminate the foreign branch income basket. In addition, carrybacks of foreign tax credits (which are permitted for one year under current law) would be eliminated, and carryforwards would be limited to five years (10 years under current law).

- **Modifications to Calculations of GILTI Inclusions.** The amounts that contribute to the calculation of a taxpayer's GILTI inclusion, including "CFC net tested income", "net deemed tangible income return", "qualified business asset investment" ("QBAI"), and interest expense would be calculated on a country-by-country basis under the W&M Budget Proposal. The amount of allowable net deemed tangible income return would be reduced from 10% of QBAI to 5% of QBAI. Because GILTI generally equals the excess of a taxpayer's net CFC tested income over the taxpayer's net deemed intangible income return, this change would generally increase the effective tax rate on GILTI.
- **Increase in Deemed Paid Tax Credits.** The W&M Budget Proposal would increase the "deemed paid" foreign tax credit that applies with respect to foreign taxes attributable to GILTI from 80 percent to 95 percent. This provision would be effective for taxable years of foreign corporations beginning after December 31, 2017.
- **Limitation on Deduction for Foreign-Source Dividends.** The W&M Budget Proposal would limit the existing deduction for foreign-source dividends received from a foreign corporation to such dividends that are received from a CFC. Because such amounts generally are already able to be distributed by CFCs tax-free to the extent they were previously taxed to the shareholder as GILTI or "subpart F income", this revision would substantially reduce the effects of the deduction for dividends received from foreign corporations. This change, together with the increases to the scope of GILTI noted above, effectively moves U.S. taxation of international activities closer to a model of taxing U.S. persons on a global basis and further away from a "territorial" system.
- **Repeal of CFC Downward Attribution.** Effective for taxable years of foreign corporations ending before January 1, 2018 and all subsequent taxable years, and taxable years of U.S. persons in which or with which such taxable years of foreign corporations end, former Section 958(b)(4), which generally prevented stock owned by a foreign person from being attributed "downward" to a U.S. person for purposes of determining whether a foreign corporation is a CFC, would be reinstated. The repeal of this rule in 2017 caused domestic subsidiaries of parent foreign corporations to be treated as owning certain stock of subsidiary foreign corporations of the parent, which caused many such subsidiary foreign corporations to be treated as CFCs even though they had few or no U.S. beneficial owners. The W&M Budget Proposal would also include a new section that would cause the GILTI and subpart F regimes to apply to foreign corporations that would be CFCs if the downward attribution rules continued to apply, but only in the case of U.S. shareholders treated as owning at least 50% of any such foreign corporation by vote or value. In addition, the W&M Budget Proposal would permit all of the U.S. shareholders of a foreign corporation that is not a CFC to elect, along with the foreign corporation, to treat the foreign corporation as a CFC. The election would be binding on all current and future U.S. shareholders of the foreign corporation.
- **BEAT Threshold and Other Modifications.** Under current law, the "base erosion anti-abuse tax" ("BEAT") is an alternative tax that generally applies to certain corporations or corporate groups with over $500 million in aggregate gross receipts and that have a "base erosion percentage" (which is generally the ratio of certain deductions for payments made to foreign related parties over all allowable deductions) above a certain threshold (which generally equals 3%). The W&M

Budget Proposal would eliminate this threshold for taxable years beginning after December 31, 2023, such that all corporations (other than RICs, REITs, and S corporations) that meet the gross receipts requirements would potentially be subject to the BEAT. It would also add the "cost of goods sold" to the base on which the tax is imposed when relevant goods are acquired from a related foreign party, except to the extent of the costs directly incurred by such related foreign party. (Alternatively, the U.S. taxpayer could elect to reduce the deemed cost of such goods by 20%.) In addition, the BEAT rate would gradually increase from its current rate of 10% to 15% in any taxable year beginning after December 31, 2025. The W&M Budget Proposal also contains various changes to the way that a taxpayer's BEAT liability is calculated.

- **Expansion of 10% Shareholder Definition for Portfolio Interest.** Under the existing "portfolio interest exemption", a person who owns 10% or more of the total voting power of a corporation is not eligible to exclude from income interest paid by such corporation. The W&M Budget Proposal would revise the definition of "10-percent shareholder" for these purposes to include persons who own 10% or more of the vote *or* value of the stock of a corporation. The amendment would apply to debt obligations issued after the date of enactment. This provision would prevent taxpayers that own large economic stakes in closely held corporations from funding such corporations with debt that is eligible for the portfolio interest exemption by issuing high-vote interests to other shareholders.
- **CFC Extraordinary Dividends.** Under current law, a dividend paid by a corporation to a domestic corporate shareholder that has held stock in the corporation for less than two years in excess of a certain percentage of the shareholder's basis in its stock of the payor is treated as an "extraordinary dividend" that reduces the shareholder's basis in such stock, and may give rise to taxable gain to the extent of the amount of the dividend that is not subject to tax in the hands of the shareholder due to an applicable dividends received deduction. Under the W&M Budget Proposal, a dividend paid by a CFC to a U.S. shareholder would be treated as an extraordinary dividend, without regard to the period the taxpayer held the stock of the CFC, if the dividend is paid out of earnings and profits of the CFC that were earned, or is attributable to gain on property which accrued, while the CFC was not a CFC or while such stock was not owned by a U.S. shareholder.
- **Partnership Interest Derivatives.** The W&M Budget Proposal would treat payments with respect to notional principal contracts calculated by reference to the U.S. source income or gain of a publicly traded partnership, including one that is not engaged in a U.S. trade or business, as "dividend equivalent amounts" for purposes of federal dividend withholding tax. Such payments would be sourced based on the residence of the payor and thus would be subject to 30 percent U.S. withholding tax (or a reduced rate if a tax treaty applies) if paid by a U.S. payor. Publicly traded partnerships would be required to provide reporting information to relevant withholding agents with respect to such payments.
- **Limitation on "Dual Capacity Taxpayers" with Respect to Foreign Tax Credits.** The W&M Budget Proposal would codify an existing regulatory rule that applies to domestic corporations that are subject to tax in and receive certain benefits from a foreign country or U.S. possession. Such a corporation would not be permitted to claim a foreign tax credit for payments that are not treated as generally applicable income taxes. A generally applicable income tax is a tax imposed on income derived from a trade or business conducted within the country and that has substantial applicability to persons who are not "dual capacity taxpayers".

D. NEXT STEPS

The House Committee on Ways and Means is currently considering amendments to the W&M Budget Proposal, after which the bill will be sent to the House Budget Committee to be consolidated with the work of other committees of jurisdiction. Many of the above provisions will be subject to substantial negotiation

with the Senate and are likely to be further revised. The full House of Representatives returns to session on September 20 and is scheduled to begin consideration of the bill on or shortly after September 27.

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